Guidelines on Exchange Traded Interest Rate Derivatives

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Guidelines on Exchange Traded Interest Rate Derivatives

1. RBI has decided to introduce exchange traded Interest Rate Derivatives (IRDs) to enable better risk management in the Indian market. In the first phase, the Securities and Exchange Board of India (SEBI) has decided to introduce anonymous order driven system for trading in Interest Rate Derivatives (IRDs) on The Stock Exchange, Mumbai (BSE) and National Stock Exchange (NSE).

The extract of the notification is reproduced below:

2. It has been decided to allow Scheduled Commercial Banks excluding RRBs & LABs (SCBs), Primary Dealers (PDs) and specified All India Financial Institutions (AIFIs) to deal in IRDs in a phased manner. In the first phase, such entities can transact only in interest rate futures on notional bonds and T-Bills for the limited purpose of hedging the risk in their underlying investment portfolio.

3. SCBs and AIFIs desirous of transacting in IRDs on the stock exchanges should take specific approval from their respective Boards covering, inter alia, the products that they may transact in, size/composition of the investment portfolio intended to be hedged, organizational set-up to monitor, rebalance, report, account and audit such transactions.

4. The following norms will be applicable for transacting IRDs on the Futures and Options (F &O) segment of the stock exchanges:

i) *Stock exchange regulation:* SCBs and AIFIs can seek membership of the F & O segment of the stock exchanges for the limited purpose of undertaking proprietary transactions for hedging interest rate risk. Those not seeking membership of Stock Exchanges, can transact IRDs through approved F & O members of the exchanges.

ii) *Settlement:*
   a) As trading members of the F & O segment, SCBs and AIFIs should settle their derivative trades directly with the clearing corporation/ clearing house.
   b) Regulated entities participating through approved F & O members shall settle proprietary trades as a participant clearing member or through approved professional/ custodial clearing members.
   c) Broker/ trading members of stock exchanges cannot be used for settlement of IRD transactions.

iii) *Eligible underlying securities:* The government securities classified under the Available for Sale and Held for Trading categories will be allowed to be hedged.

iv) *Hedge criteria:* Interest Rate Derivative transactions undertaken on the exchanges shall be deemed as hedge transactions if and only if,
   a) The hedge is clearly identified with the underlying government securities in the Available for Sale and Held for Trading categories.
   b) The effectiveness of the hedge can be reliably measured.
   c) The hedge is assessed on an ongoing basis and is "highly effective" throughout the period.

v) *Hedge Effectiveness:* The hedge will be deemed to be "highly effective" if certain stipulated conditions are specified. For details refer the notification.

vi) *Accounting:* The Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) is in the process of developing a comprehensive Accounting Standard covering various types of various types of financial instruments including accounting for trading and hedging. However, as the formulation of the Standard is likely to take some time, the Institute has brought out a Guidance Note on Accounting for Equity Index Futures as an interim measure. Till ICAI comes out with a comprehensive Accounting Standard, SCBs and AIFIs may follow the above guidance note mutatis mutandis for accounting of interest rate futures also.

vii) *Capital adequacy:* The net notional principal amount in respect of futures position with same underlying and settlement dates should be multiplied by the conversion factor to arrive at the credit equivalent. Refer the RBI notification to understand 'Conversion factor'.

viii) *ALM classification:* Interest rate futures are treated as a combination of a long and short position in a notional government security. The maturity of a future will be the period until delivery or exercise of the contract, as also the life of the underlying instrument.

ix) *Use of brokers:* The existing norms of 5% of total transactions during a year as the aggregate upper contract limit for each of the approved brokers should be observed by SCBs and AIFIs who participate through approved F & O members of the exchanges.

x) *Disclosures:* The regulated entities undertaking interest rate derivatives on exchange may disclose as a part of the notes on accounts to balance sheets specified information. (for details refer RBI notification).

xi) Reporting: Banks and specified AIFIs should submit a monthly statement to DBS or DBS (FID) respectively as per the format.(For format refer to the RBI notification) ■